

# Role of Islamic Banking and Conventional Against Poverty with The Dual Banking System

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**Abstract.** Islamic banking in Indonesia presents in a dual banking system. Islamic banking is expected to contribute more in the process of economic development and improving people's welfare. The main objective of this study is to analyze the role of financing Islamic banking and conventional banking credit to the improvement of people's welfare as measured by reductions in poverty. The study was conducted using the explanatory method, applying the panel regression estimation techniques simultaneously with the Two Stage Least Square method (TSLS) data from the period of 1992-2012. Results of the study reveals that the increase of financing Islamic banking and conventional banking credit assign roles to poverty reduction in Indonesia. The role of Islamic banking financing is lower than conventional bank credit role in reducing poverty. In addition to improve financing and credit, changes should be applied in the value of the instruments of monetary policy, economic growth, unequal distribution of income and the depreciation of the local currency that contribute towards poverty conditions.

**Keywords:** income distribution, poverty, credit, financing, economic growth

## Introduction

Since the 1990s the phenomenon of Islamic banking emerged in the banking system in Indonesia. The presence of Islamic banking will also mark the presence of dual banking system. Islamic banks is experiencing rapid growth, especially in the period before and after the economic crisis of 1998. In the period of 1992-2012 the growth of Islamic bank financing is on average of 61.98%. Financing growth exceeded the growth rate of credit. In the period 1992-2012 the growth of bank loans by an average is 18.22% per year.

Islamic banks have several advantages compared to conventional banks. The principles of justice and expediency of Islamic banks will encourage the creation of synergies that are beneficial to banks, customers and communities (Burhanuddin A, 2003). During the crisis in 1998 Islamic banks have a higher intermediation ratio, asset quality and better capitalized than conventional banks (Beck, Kunt and Merrouche, 2013). Asset growth and financing of Islamic banks

contributed to a better financial and economic stability compared to the conventional banks (Hasan & Dridi, 2010). Prohibition of usury in the process of financing (credit) and the reorganization of financial intermediation on the basis of profit-loss sharing in Islamic banks can help the Islamic economic management in minimizing unproductive elements and speculative demand for money aggregate. This condition can not be realized in the interest-based economic system. Interest rate produce inefficiencies in the allocation of public resources and increasing inequality in the distribution of income and wealth (Chapra, 2007).

In countries that implement dual banking system (conventional and Islamic), the monetary authorities have a responsibility to maintain monetary stability and financial system, as well as to synergize the two systems to optimize the benefits for the welfare of the community. The essence and characteristics of each system should be maintained and should not be fused from one system in to another. Continuous

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harmonization of ensuring financial system stability, accelerating economic activity and improve the well-being evenly (Ascarya & Hasanah, 2008). The impact of monetary policy short-term conventional and Islamic systems are no different. But in the long run Islamic economic system gives a higher impact on savings and investment and will stimulate faster economic growth. Advantages of the system of Islamic banks depends on the ability of the government to provide a favorable macroeconomic environment and an emphasis on the importance of institutional reforms and development (Elhiraika, 2004). Islamic banks provide hope and an alternative to efforts to improve welfare through increased economic growth and poverty reduction.

The increase of financing Islamic banks and conventional bank loans, in the period 2000-2012, drastically reduce poverty in Indonesia. In 2000 the poverty rate in Indonesia amounted to 18.47% and in 2012 the poverty rate fell to 11.66%. In this period it was revealed that the poverty rate in Indonesia has decreased on average by 0.7% per year. The decline in the relative poverty rate is not in line with economic growth. Indonesia's economic growth fluctuate, in contrast with economic potential possessed and global development of the economy in general. Empirical studies of Bourguignon (2002) and Lopez (2003) says that economic growth will reduce poverty if the unequal distribution of income in the economy is still high. Islamic bank is a financial institution that has the potential to boost economic growth and reduce poverty.

Although it has been successfully maintained the real sector in a crisis era, of 1997-2000, Islamic banks still have less performance compared to conventional banks. Islamic banks have not been able to provide significant contribution in improving the welfare of the people and boost the economy of the Indonesian population, especially the marginal economic actors, which is the 'ultimate objective' of the Islamic banking sector (Erie Febrian, 2008). The market opportunity for Islamic banks is very large, and it could provide a better commercial achievement and provide a greater contribution to the alleviation of poverty in Indonesia.

Referring to the financing of the development of Islamic banks and conventional bank loans as well as the conditions of poverty in Indonesia, the

question that received the most attention in this study is whether the financing of Islamic banking and conventional banking credit role in reducing poverty in line with efforts to boost economic growth. What is the role of Islamic banking compared to the conventional banking in overcoming poverty? how is the role of the monetary authorities and other relevant macroeconomic indicators in the push to improve the condition of poverty? In accordance with the formulation of research questions, the objectives of this study are; (1) to determine the role of Islamic banking financing and conventional bank loans in reducing poverty; (2) to compare the role of Islamic banking financing with conventional bank credit towards poverty reduction; (3) to know the role of the monetary authority, economic growth, unequal distribution of income and the exchange rate in reducing poverty.

## **Islamic Banking and Poverty**

The existence of a formal judicial Islamic Bank beginning with the enactment of Law (UU) No. 7 of 1992. Attendance Law 10/1998 on banking, the Law No. 23/1999 on Bank Indonesia and the Law 21/2008 about Islamic banking has provided a stronger basis for the existence of Islamic banks in a dual banking system in Indonesia. In the dual banking system, conventional banks and Islamic banks can operate side by side in the whole of Indonesia. Bank Syariah according to Law No. 21 / 2008 was banked running their business based on Sharia principles and by type consisting of Islamic Banks and Islamic Rural Bank Financing.

Islamic Banking provides interest-free service to its customers. Payment and withdrawal of interest is prohibited in all transactions. The prohibition of interest rates is what distinguishes the Islamic banking system (Islam) with the conventional banking system (Algaoud & Lewis, 2001). In carrying out their functions and roles, Islamic bank operational system is determined by five basic concepts of contract, namely (1) the Agreement pure loan (al-wadiah); (2) Agreement for the results (shirkah); (3) Akad purchase (at-tijarah); (4) akad rental (al-ijara); (5) the contract services (al-AJR walumullah). Sourced from the five basic aqad found this Islamic bank product. The main purpose of the existence of Islamic banking is to provide the largest benefit or benefit to society (Iqbal, 2008).

In general, the development of Islamic banks associated with the three main interests: first, the business interests of Islamic banks to conduct banking business in a healthy, competitive and sustainable to achieve earnings expectations in accordance with the rules of sharia. Second, the interest of central banks and financial authorities to achieve monetary stability and financial system. Third, The interest of macro-economic development in Islamic banks for society and the economy. The enormous potential of Islamic banks must be backed by a wide range of facilities and the appropriate rules, so that its presence can make a real contribution to the economy and society. This condition is in accordance with the opinion of Chapra (1996), linked to Islamic monetary policy objectives, namely achieve: (1) The economic feasibility of full employment and optimum level of broad-based economic growth; (2) socio-economic justice with equitable distribution of income and welfare 3) Stability in the value of money so as to allow a medium of exchange can be used as a unit of account, a benchmark fair in repaying the loan and the exchange rate stable and effective of all the services of the banking system

One of the problems associated with prosperity in society is the problem of poverty. There are many explanations of the causes of poverty. First, micro poverty arise because of the inequality of resource ownership patterns which lead to an unequal distribution of income. Poor people only have a limited amount of resources with low quality. Second, poverty arise from the differences in the quality of human resources. The quality of human resources is low means low productivity, which in turn affects the low wages received. The low quality of human resources is due to lack of education, the fate of the less fortunate, discrimination or because of heredity. Third, poverty arises from the difference in access to capital (Mudrajat Kuncoro, 2010).

Studies by Knowles (2005) found a strong correlation between economic growth and poverty reduction in developing countries. According to Hoeven (2004) the cause of poverty in many developing countries due to the dichotomy (dualism) between a traditional economy (rural) and urban economy as well as the changes in the economic structure of a country. Efforts to reduce poverty could be done by encouraging the growth of the agricultural sector and poor attention to group dynamics. Ida Zulfaida et al. (2015) explains

that through PNPM program, the agricultural sector produced the best performance. These findings reveal the importance of community development programs in the agricultural sector to reduce poverty in rural areas. According to Nasution et al. (2014: 137-148) implementation of development programs to reduce poverty in rural areas is done by facilitating and improving people's access to capital. Poor households could increase access to social capital through participation in community activities (social organization or agency of the village).

Ravallion and Chen (2003), suggests the need to pay attention to the dynamics among the poor to overcome poverty. Poor people are not regarded as a homogenous group, given the poverty response to changes in economic growth and income distribution is between rural and urban areas. Research shows that rural poverty is more responsive to economic growth than urban poverty, but on the other hand urban poverty is more responsive to income distribution. The study De-Janvry & Sadoulet (1999) show that economic growth can reduce poverty and inequality effectively only if poverty and inequality are not too high in initial and relatively occurred in high education level of society. It is also found asymmetry in the impact of economic growth on poverty reduction and the impact of economic growth on poverty will be greater than the impact of the increase.

Studies on the effect of the sectoral composition of economic growth and the initial conditions of a region towards poverty reduction made by Ravallion and Datt (1999) and Bigsten & Shimeles (2005). The study results reveal the importance of considering the dynamics of inter-sector in developing strategies to reduce poverty. Hoeven (2004) look at the relationship between changes in economic structure, income inequality and poverty in a country. The poverty rate in Indonesia is still high, while economic growth is relatively high and stable. At the national level, the dynamics of poverty in Indonesia are often not in line with economic growth rates. Some economic growth period characterized by increased poverty. Suselo and Tarsidin (2008) showed that the agricultural sector is the highest contributor to poverty in almost all regions, the most responsive in reducing poverty. Almost in all areas of agriculture, plantation and fishery become major contributor to the high rate of poverty in Indonesia.

Poverty is a complex phenomenon resulting from the lack of growth and inequality (Sirageldin, 2000). Based on the evidence of conceptual and empirical, it can be concluded that Islamic ethics support a poverty reduction strategy based on the principle of promoting economic growth and equitable distribution of productive. The study by Paci, et al., (2004) showed that; (1) The ability of the economy to create jobs affect the relationship between poverty and economic growth; (2) Increased productivity leads to a decline in employment and increase poverty; (3) Fiscal policy and social protection have an impact on income distribution and poverty. Asep Suryahadi (2012) showed a significant decrease in the annual poverty rate in the post-crisis period. Growth in the services sector provided the largest contribution to poverty reduction in rural and urban areas. Growth in the industrial sector largely become irrelevant for poverty reduction in the post-crisis period despite the sector contributing the second largest share of GDP. Growth in the agricultural sector plays an important role in the countryside alone. The findings show the need for the formulation of effective strategies to promote sectoral growth in order to accelerate the pace of poverty reduction.

The role of banks in addressing the problem of poverty refers to the study by Mallick (2008), which reveals that a key component of monetary policy to tackle poverty is through the availability of credit for businesses. Credit expansion, particularly for agriculture, contributes significantly to poverty reduction. It revealed the importance of credit financing as an instrument of macro policy in overcoming poverty. There is a relationship between macroeconomic policies and poverty. Effects of development

expenditure and financing policies directly affect poverty after taking into account the effects of sectoral output and price ratio. Revealed the importance of the distribution of income in the agricultural sector as a mechanism for reducing poverty. Fiscal policy and monetary policy through the expansion of bank credit to the agricultural sector contributes significantly to poverty reduction. According to Sanadjihitu Sangadji, et al. (2015) poverty reduction must be based on the characteristics of communities and regions. Poverty alleviation policies carried out by increasing levels of public education, public health level, the competitiveness of human resources, purchasing power, and controlling population growth. Islamic banking has the potential to play a role in overcoming poverty through financing productive sectors in rural areas. By empowering the community through the availability of funds from Islamic banking, efforts to reduce poverty could be done. According to Hailu and Weeks (2011), monetary policy aims to prevent inflationary pressures, encouraging private sector investment, and exchanging rate policies which focused on achieving international competitiveness, in order to boost growth and reduce poverty. Stabilization of inflation and efforts to boost economic growth can not be run concurrently. According to Blanchard and Gali (2008) there is a trade-off between stabilizing inflation and unemployment, this condition raises implications for the need for optimal monetary policy. Monetary policy is proven to reduce the weighted-average unemployment and inflation fluctuations. Monetary control less precise increasing economic uncertainty in improving social welfare and reduce poverty. Referring to the review of theoretical, empirical studies and research objectives, the research framework

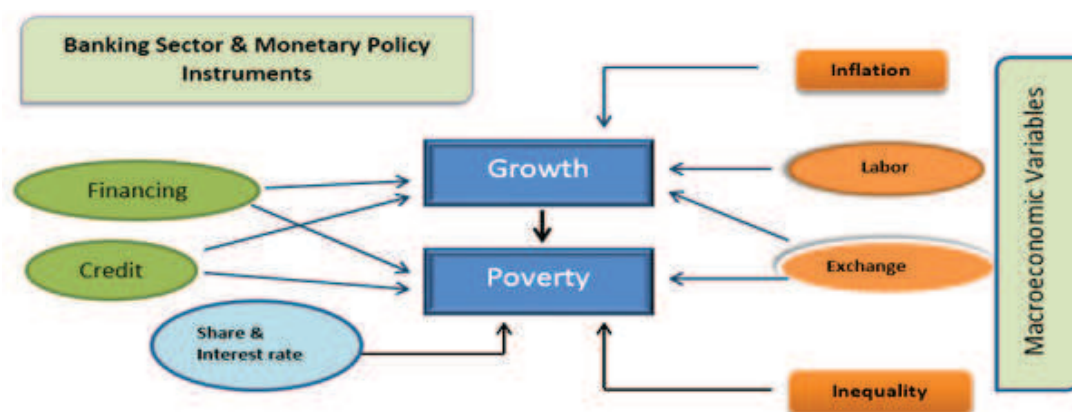


Figure 1. Framework Research



is presented as figure 1.

### Simultaneous Equation Model

This research is a descriptive study with a pattern of causal-comparative and correlational, which will describe, explain and answer the problems of the phenomenon of Islamic banking and its relationship with the problems of poverty and economic growth in general. The object of this study includes three important components, namely the Islamic banks, economic growth and poverty. The study was conducted for the case of Islamic banking in Indonesia from 1992 to 2012. The analytical method used in this research is the method of qualitative analysis and quantitative analysis methods by applying the simultaneous regression estimation techniques with Two Stage Least Square method (TSLS) (Gujarati, 2009). Overall the data used in this research is secondary data from various official sources.

This study uses panel simultaneous equation model using two stages regression techniques (two stages least square) to see the role of Islamic banks and the financing of economic growth against poverty in Indonesia. The model of this simultaneous, economic growth and poverty is treated as an endogenous variable, while the Islamic bank financing, loans, deposits of Islamic banks, variable government policy (interest rate SBIS and revenue sharing SATISFIED) and macroeconomic variables other (credit, labor, value The exchange and inequality) is treated as an exogenous variable. Common specifications of structural equation in Growth (GRW) and Poverty (Pov) used in this study are:

$$\begin{aligned} \text{Grw} &= f(\text{Int, Shr, Crd, Fin, Cpi, Exr, Lab}) \dots (1) \\ \text{Pov} &= f(\text{Int, Shr, Crd, Fin, Exr, Grw, Dis}) \dots (2) \end{aligned}$$

where:

Grw = Riil GDP growth

Pov = Poverty rate

Int = Interest rate monetary policy

Shr = Sharing ratio Islamic monetary policy

Crd = Conventional bank loans

Fin = Islamic banking financing

Cpi = Consumer price index

Exr = Exchange Rate

(the rupiah against the dollar USA)

Lab = Labor

Dis = Index of inequality (Gini coefficient)

Based on 2 structural equations, variables have interdependence with one another, as the study variables as endogenous and exogenous variables (predetermined variable). This condition shows the model of this research is eligible to be applied through

the simultaneous equations.

All structural equations are assumed to have relationships that are linear, then the form of the equation can be formulated in such a way that qualifies linear regression model.

### The Role of Islamic and Conventional Bank on Financing

The estimation results of the economic growth model (GRW) and poverty (POV) in the table below shows the relationship between the negative and significant improvement of conventional bank loans (CRD) and the Islamic bank financing (FIN) with poverty reduction. With a coefficient of -0.010 Islamic bank financing, the results of this study show that an increase in funding affect the poverty figures in spite of the decrease which not too large (in-elastic). The role of Islamic banking in efforts as an attempt to reduce poverty although it is a small role that have been shown in the appropriate direction.

In line with Islamic bank financing, improvement of the conventional bank loans contribute to the decline of the poverty rate. With a coefficient of -0.171 research, conventional bank loans contribute to the decline of poverty despite the changes are not too large (in-elastic). The role of conventional banking to reduce poverty have been shown in the appropriate direction, eventhough it is a small role. The role of conventional bank loans is greater than the Islamic bank financing role in reducing poverty. Systematic and more effort is needed to improve the financing role of Islamic banking and conventional banking credit to reduce poverty.

Explanations about the increased role of financing Islamic banks and conventional bank credit towards poverty reduction, refer to some of the following research. The results of the study by Mallick, (2008), Suselo and Tarsidin (2008) and Asep Suryahadi, et al. (2012), shows that the agricultural sector is the highest contributor to poverty in almost all areas. Agriculture is also the most responsive sector to the high growth elasticity of poverty reduction. The rising share of the manufacturing sector would reduce poverty, while the decline in the share of agriculture, plantation and fisheries would increase poverty. Monetary policy through the availability of credit, are key components which determine the level of

poverty. The expansion of bank credit, especially for agriculture, contributes significantly to poverty reduction.

In the period 2001-2012, the average growth of conventional bank loans and financing Islamic bank in Indonesia amounted to 21.48% and 67.02% per year. Conventional bank loans allocated to the agricultural sector amounted to 7.65% and the Islamic bank financing allocation for agriculture amounted to 3.98%. Average allocation of credit and financing Islamic banks are channeled to the service sector respectively 5.7% and 8.45%. By comparing the high growth rates of credit and financing with a lower portion of the allocation of credit and financing for the agricultural sector and the service sector, the estimated potential credit support conventional bank and Islamic bank financing efforts to reduce poverty problem is not too large.

Efforts to reduce poverty could be done by encouraging the growth of the agricultural sector and pay attention to group dynamics. Financial institutions, particularly the Islamic banking can take a bigger role in tackling the problem of poverty. The development program to reduce poverty in rural areas is done by facilitating and improving people's access to capital. Community empowerment programs in the agricultural sector proved to be essential for reducing poverty in rural areas (Ida Zulfaida et al., 2015). The results of different studies by Asep Suryahadi et al. (2012) revealed that the growth

of the service sector provided the largest contribution to poverty reduction in rural and urban areas. Nevertheless, growth in agriculture remains critical to reducing poverty in rural areas.

Bank is part of a country's monetary system so that its presence can not be separated from the various policies implemented by the monetary authorities. The estimation results indicate that conventional monetary policy instruments (INT) showed positive and significant correlation with poverty (POV). With a coefficient of 0.308 research shows that changes in poverty as a result of changes in the benchmark interest rate the central bank's monetary policy is in elastic. Each 1% increase in the benchmark rate of the central bank policy will be followed by increasing levels of poverty with a smaller portion of the increase.

In line with changes in the policy rate, the increase in the profit sharing ratio Islamic monetary policy instrument (SHR) will be followed by increasing poverty. With a coefficient of 0.663 research shows that changes in poverty as a result of changes in the benchmark interest rate the central bank's monetary policy sharia is in-elastic. Each 1% increase in the benchmark rate of the central bank policy will be followed by increasing levels of poverty with a smaller portion of the increase. The role of Islamic monetary policy instrument is more elastic than the conventional monetary policy instruments in influencing poverty. Each 1% increase in

**Table 1**  
**Research Model Estimation Results**

Growth Model (Grw)					Poverty Model (POV)				
Variable	Coefficient	Std. Error	t-Statistic	Prob.	Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	-1.254	0.093	-134.85***	0.0000	C	-5.975	1.205	-4.958	0.0000
INT	-0.0035	0.00014	-25.16***	0.0000	INT	0.308	0.140	2.2043**	0.0346
SHR	-0.0007	0.00015	-4.67***	0.0000	SHR	0.663	0.193	3.4396***	0.0016
CRD	0.2252	0.0014	160.33***	0.0000	FIN	-0.010	0.0052	-1.8948*	0.0669
FIN	0.0481	0.0009	52.06***	0.0000	CRD	-0.171	0.0304	-5.6128***	0.0000
CPI	-0.3132	0.0019	-168.82***	0.0000	GRW	1.410	0.2183	6.4541***	0.0000
EXR	0.00234	0.0002	114.44***	0.0000	DIS	1.187	0.2507	4.7360***	0.0000
LAB	0.90135	0.0053	169.56***	0.0000	EXR	0.121	0.0204	5.9380***	0.0000
Adjusted R <sup>2</sup>	0.995501		Prob(F-statistic)	0.0000	Adjusted R <sup>2</sup>	0.894329		Prob(F-statistic)	0.0000
F-statistic	1.631.496				F-statistic	5.057.287			

Source: Data processing results  
Description: Significant at the critical value \*)10%, \*\*)5%, \*\*\*)=1%

the profit sharing ratio Islamic monetary policy will have an impact of increasing poverty is greater than the impact of interest rate hikes of unconventional monetary policy. The central bank needs to be more carefully to increase the profit sharing ratio Islamic monetary policy reference for impact is worse for poor conditions.

The poverty problem in addition to associate with banking operations are also closely related to the process of development and economic growth. The estimation results indicate that economic growth (GRW) positive and significant impact on poverty (POV). With a coefficient value of 1.410 indicates that economic growth affects poverty elasticity. Every economic growth will be followed by higher increase in the poverty rate. The results are consistent with studies of Dollar and Kraay (2002). Using data from 80 developing countries within a period of 40 years revealed that every 1% increase in economic growth led to an increase in the poor population by 1%.

Explanation of the results of research can refer to the results of the study by De-Janvry and Sadoulet (1999), Bourguignon (2002), Lopez (2003) and Lombardo (2008) which revealed that economic growth will reduce poverty in the event that a progressive income distribution. Indonesia has a high inequality of income distribution Gini coefficient with an average of 0.41 in the 2011-2015 period. This condition shows that the efforts to reduce poverty through increased economic growth would lead to the opposite problem. Poverty will continue to increase, upon the unequal distribution of income which is still high.

The results of model estimation of poverty show that unequal distribution of income (DIS) positive and significant impact on poverty (POV) to the value of the coefficient value of 1.187. These results indicate that the unequal distribution of income is a major cause of poverty. The research result is in line with the study of Sirageldin (2000), Islam (2004), Bigsten and Shimeles (2005), revealed that poverty is a complex phenomenon resulting from the lack of growth and unequal distribution of income. The high number of unequal distribution of income has a major impact on poverty.

Efforts to improve and lower the unequal distribution of income is a necessity to reduce poverty in Indonesia. Assessment of Ravallion (2001), Son & Kakwani (2003) and Bourguignon (2002) reveals that countries with high rate of inequality of income distribution medium and low, level regardless of the rate of economic growth, with more and more down the inequality distribution of income, resulted in the greater decrease poverty.

The overall relationship between exogenous and endogenous variables in the model of growth and poverty models is presented in Tabel 1.

### **In the Model Economic Growth and Poverty**

Poverty is happening other than specified by internal economic conditions in the country, is also influenced by global developments abroad. The results of model estimation of poverty show that the exchange rate (EXR) positive and significant impact on poverty (POV) with a coefficient of 0.121. The increase in the exchange rate (depreciation) of local currency in the short term resulted in a change in relative prices the price of imported goods in the country become more expensive and the price of export goods abroad become cheaper. This will potentially lead to a trade surplus and increased economic activity. In the long term, along with the high dependence of the domestic industry on imported components, and the inability of local products to compete both domestically and abroad, the depreciation of the local currency resulted in the opposite outcome. A deficit of the trade balance, economic activity has decreased and this condition increases poverty.

According to Haris Munandar (2013) in general, the poor tend to save their money and the declining value of money is likely to always exist. It causes the real value or purchasing power of their money will decrease. The rich on the contrary tend to be more creditworthy and have better access to financial instruments that provide hedging against currency debasement. Therefore, a decrease in the value of the currency is often seen as a form of tax that is taken from the poor and given to the rich. The poor tend to be the most disadvantaged groups when inflation occurs. The decline in value of the currency



can lead to poor groups who do not fall into the abyss of poverty. Control of the value of the currency in the country seems to be a necessity in order to prevent increasing poverty.

## Conclusions

The results of this study revealed that; (1) Increased financing Islamic banking and conventional banking credit contribute to poverty reduction in Indonesia. The role of Islamic banking and conventional towards poverty reduction is not too large (in-elastic); (2) The role of Islamic banking financing smaller than a conventional bank's role in reducing poverty in Indonesia. The lower the role of Islamic banking was related to the limited amount of financing channeled to the economic sectors that contribute to poverty reduction; (3) In addition to financing and bank loans, the increase in value of the instruments of monetary policy (Islamic & conventional), economic growth and foreign exchange rates contributed to increasing poverty in Indonesia. The role of economic growth to the rising poverty rate is predicted as a result of persistently high inequality of income distribution in Indonesia.

Many diagnostic suggestions aimed at improving and optimizing the role of banks in improving the poverty; (1) Islamic banks should be more focused on the primary purpose of driving the activity of the real sector and should take risks in accordance with the principles of justice in Islamic economics so that the existence of Islamic banking will play a greater role on economic growth and poverty reduction, (2) The central bank formulates monetary policy instruments with reference to the condition of the real sector (the goods market). Monetary policy as such will provide more optimal and far between the trade of price stability with economic growth and poverty reduction, (3) Increase the income distribution which have an impact on increasing economic growth accompanied by a decrease in poverty; (4) Exchange rate policy left to the market mechanism. Strengthening the exchange rate reflects the ability of the economy in the face of global competition, will encourage economic growth that is accompanied by the occurrence of price stability and poverty reduction.

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